## TABLE OF CONTENTS

## TABLE OF FIGURES

# 1. INTRODUCTION

This Section provides an overview of the *Project EASI/ED (Easy Access for Students and Institutions/US Department of Education) Best Practices Study on Outsourcing*. It provides background on the project, explains the purpose of the study, and defines "best practices." It explains the approach used to create the study and outlines the document organization.

## 1.1 Project EASI Overview

Project EASI is an effort by members of the postsecondary education community to define and implement a customer-focused "system" to support postsecondary education. The Project EASI vision encompasses the entire postsecondary education community and its current customers. This includes prospective students, families, students, borrowers, schools, lenders, secondary markets, servicers, guarantors, state agencies, ED, professional organizations, and external organizations that may wish to share appropriate information (e.g., employers, financial counselors). Project EASI/ED encompasses ED's internal areas of responsibility as they relate to the overall vision, as well as ED's interactions with the postsecondary education community.

## 1.2 Document Purpose

A number of drivers are causing ED to reconsider its approach to contracting for services. Firstly, the Government Performance and Results Act (GPRA), directives from the Office of Management and Budget (OMB), and ED's Strategic Plan for the 1998 - 2002 time-frame all focus attention on managing the delivery of services through specific, measurable performance goals. These performance goals emphasize measuring and evaluating the results of an activity rather than prescribing the inputs or processes of an activity.

Secondly, the Band Strategy is a vision for outsourcing many of the key operational functions involved in delivering Student Financial Assistance (SFA). The Band Strategy would deliver services in a manner that is very different from today. Finally, Project EASI/ED may well have some of its functionality implemented through outsourcing. ED is at a critical point in deciding its outsourcing strategy.

The purpose of this document is to highlight best practices in outsourcing. "Best practices" are processes, technologies, or organizational structures that can lead to superior performance. Outsourcing is an arrangement by which an organization passes operations for one or more elements of its business function to an external service provider.

This best practices study is based upon the lessons learned by organizations that have outsourced information technology and business process functions, and upon published research. The study addresses the following main topics.

- What outsourcing is and how the outsourcing relationship is defined
- Why organizations outsource
- What functions should be considered for outsourcing
- How to establish and maintain an effective outsourcing relationship

## 1.3 Approach

To develop the *Project EASI/ED Best Practices Study on Outsourcing*, the team followed a structured, four-step approach to study other organizations and to identify best practices.

1. Perform secondary research
2. Identify subject matter experts

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3. Conduct interviews with subject matter experts
4. Analyze findings and select best practices

These steps are detailed below.

### 1. Perform secondary research

The team gathered articles and other documents related to outsourcing in order to identify best practices. The articles and documents used to define outsourcing, to explain why companies outsource, and to describe the steps companies take to outsource came from the major secondary sources listed below.

1. KnowledgeView, Price Waterhouse's proprietary research service
2. Gartner Group Research Database
3. Forrester Research Database
4. Faulkner's Advisory on Computer and Communications Technologies (FACCTS) Database
5. Tower Group Research Database
6. The Outsourcing Institute reports and website on the World Wide Web

### 2. Identify subject matter experts

After reviewing secondary sources, the team identified subject matter experts within Price Waterhouse based on the characteristics listed below.

1. Depth of experience proven by involvement in successful outsourcing engagements
2. Participation in outsourcing operations similar to operations performed by ED, e.g., outsourcing work with organizations that originate and maintain loans, such as banks and financial service institutions

The following subject matter experts were chosen for interviews.

1. Mr. Dennis Highlander – a Price Waterhouse LLP partner
2. Mr. John Simke – a Price Waterhouse LLP partner

In addition, the team identified a subject matter expert from the public sector to address government specific issues.

1. Mr. John Lainhart – the Inspector General of the U.S. House of Representatives

### 3. Conduct interviews with subject matter experts

During each interview, the team followed a detailed questionnaire to draw upon the subject matter expert's experience on best practices in outsourcing. (See Appendix B for questionnaires.) Different questionnaires were used to gather general outsourcing information and to review government-specific outsourcing issues.

### 4. Analyze findings and select best practices

Upon completing the secondary research and interviews, the team analyzed the most apt materials and selected key findings. The key findings are grouped into success factors and pitfalls for different outsourcing topics.

### 1.4 Document Organization

The remainder of the *Project EASI/ED Best Practices Study on Outsourcing* comprises the sections listed below.

- **Section 2. Overview of Outsourcing.** Introduces the concept of outsourcing, starting with an outsourcing definition and concluding with outsourcing market trends.
- **Section 3. Key Findings.** Outlines the stages of the outsourcing relationship. Discusses specific outsourcing

topics, or subject areas, within each stage.  Describes each subject area, lists examples, describes success factors and potential pitfalls, and highlights the implications for ED.

- **Section 4. Summary.**  Summarizes the key findings that can guide an organization through the process of establishing and maintaining an effective outsourcing relationship.
- **Appendix A: Acronyms.**  Definition of acronyms used in the document.
- **Appendix B: Interview Scripts.**  Interview templates used to conduct subject matter expert interviews.
- **Appendix C: Interviews.**  Subject matter expert interview transcripts.
- **Appendix D: Sample Contract Outline.**  Sample contract outline for use as reference.
- **Appendix E: Bibliography.**  Suggested reading and references.

## 2.  OVERVIEW OF OUTSOURCING

This Section introduces outsourcing.  Subsection 2.1 gives an overview of two major types of outsourcing, Information Technology (IT) outsourcing and Business Process Outsourcing (BPO).  Subsection 2.2 highlights outsourcing trends.

In today's dynamic and competitive business environment, organizations are finding it increasingly difficult to adapt to the changes necessary to remain a key player.  As a result, many organizations have chosen to outsource functions outside their core competencies rather than to keep experts in-house.  This decision may allow organizations to focus on their mission critical goals and cost management.

Outsourcing is simply an arrangement by which an organization passes operations for one or more elements of its business function to an external service provider.  Typically, these arrangements are for a minimum of 3 years, with 5 to 10 years being more common.  After both parties document the arrangement in a contract, the external service provider assumes operational and financial responsibility, usually for a fixed price.

### 2.1  What Is Outsourced

The next question is, what functions are businesses outsourcing?  Few organizations have the resources to develop and maintain best-in-class capabilities in every aspect of their businesses.  Accordingly, a growing number of organizations are focusing resources on core competencies.  Core competencies are the capabilities that give organizations a competitive advantage in their markets, and what the organization's customers value most.  Functions outside core competencies are the most likely candidates for outsourcing.  These functions frequently are in information technology or are business processes.

There are distinct differences between outsourcing IT functions and outsourcing business processes.  IT outsourcing has evolved into a commodity where many service providers are technically competent to manage the outsourced functions.  On the other hand, BPO is relatively new and often requires more service provider flexibility.  Thus, IT outsourcing relationships tend to emphasize the contract while BPO works best when the organization and service provider establish a partnership relationship.

### 2.1.1  IT Outsourcing

Since the operational management of IT is one of the most dynamic and costly aspects of any business, it tends to be one of the most widely outsourced.  The decision to transition from legacy systems and the need to integrate new technologies into existing systems are two common drivers for outsourcing.  As these IT advancements become more prevalent within the systems and networks of an organization, so can the need to outsource.  Faulkner Information Services estimates that by the year 2000, "nearly 50% of IS [Information Systems] organizations will outsource one or more of the major end-user computing functional areas, such as desktop services, network systems management, and help desk."[1]  Figure 2-1 depicts the amount of money spent worldwide on IT outsourcing in 1996 along with a projected amount for the year 2001.
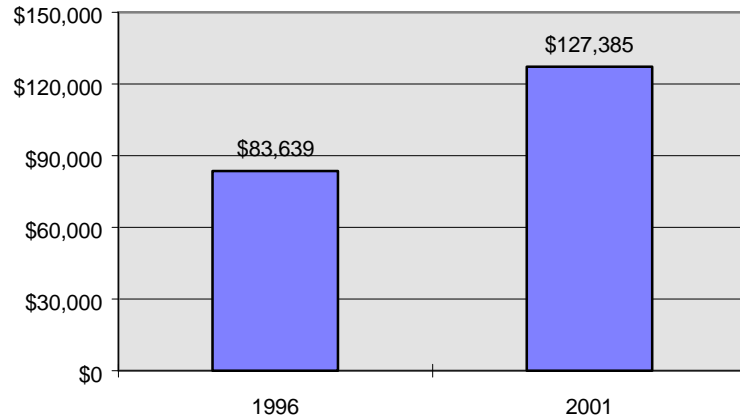
**Figure 2-1: Worldwide IT Outsourcing Spending, 1996-2001 (US$M)**

Source: "1997 Worldwide and US Outsourcing Markets and Trends", International Data Corporation, September 1997.

Currently, outsourced IT services are categorized into five areas: data center, desktop, network, web, and application development and maintenance. The services fall under each category, as described below.

- **Data Center –** Asset and inventory management, architecture and capacity planning, performance management, disaster recovery and backup, security, configuration management, training, and documentation.
- **Desktop** – Asset and inventory management, product evaluation and selection, training, configuration management, software metering and distribution, and standard setting.
- **Network** – Architecture and capacity planning, performance management, troubleshooting, configuration management, asset and inventory management, disaster recovery, fault management, product evaluation and selection, security,

training, cabling and wiring, software metering and distribution, and operations management.

- **Web** – Web site and page design, hosting, security, architecture and capacity planning, fault management, performance monitoring, e-mail, database services, training, change management, and connectivity.
- **Application Development and Maintenance** – Application development, configuration management, change management, testing, technology migration, user support, documentation, and maintenance.

Figure 2-2 is a representative sample of what IT functions organizations outsource according to Forrester Research. Forrester interviewed Management Information Systems (MIS) managers at 50 Fortune 1000 firms to determine what functions organizations were outsourcing the most. Figure 2-2 depicts Forrester's categorization of the survey results. The percentages reflect the number of organizations outsourcing a particular function out of the total surveyed.
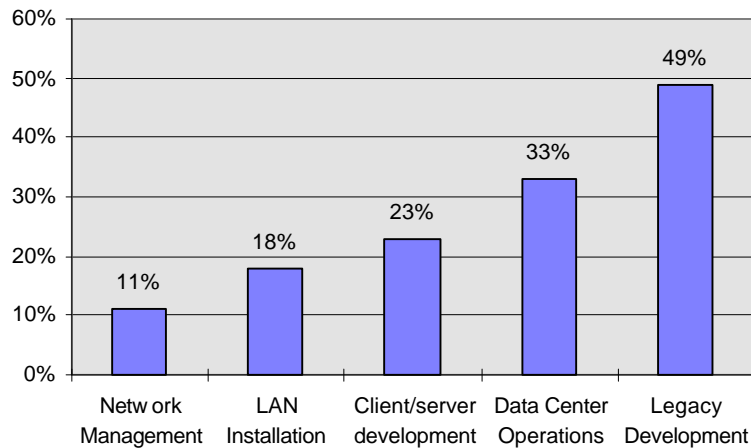
**Figure 2-2: What Organizations are Outsourcing**

Source: "New World Outsourcing", Forrester Research Database.

## 2.1.2  Business Process Outsourcing

Although IT functions still dominate outsourced functions, organizations are now considering other parts of the organization as outsourcing candidates.  BPO is the outsourcing of specialized services whereby a service provider assumes responsibility for managing an entire business process, including supporting staff and information technology, to improve business performance.   Specifically, BPO could include the following processes.

- Purchasing and disbursement
- Order entry, billing and collection
- Human resource administration
- Cash and investment management
- Tax compliance

- Internal audit
- General accounting and the generation of financial data

Figure 2-3 depicts the amount of money spent worldwide on BPO outsourcing in 1996 along with a projected amount for the year 2001.  (For comparison to IT outsourcing, see Figure 2-1.)
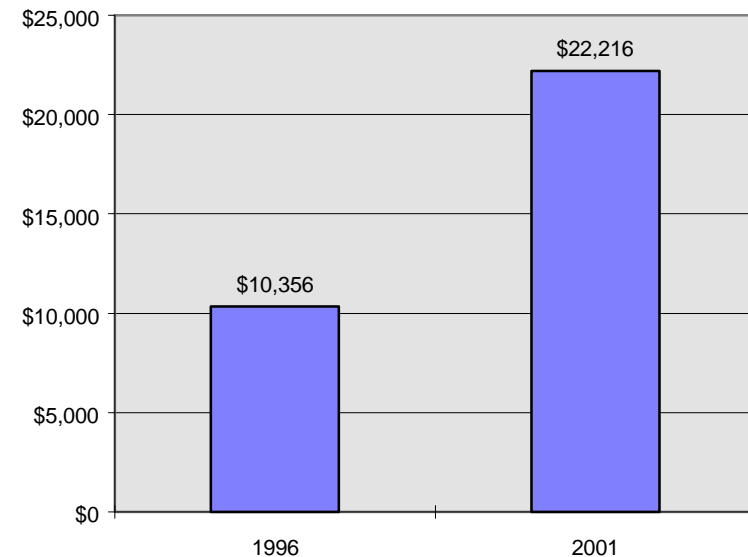
**Figure 2-3: Worldwide Business Process Outsourcing Spending, 1996-2001 (US$M)**

Source: "1997 Worldwide and US Outsourcing Markets and Trends", International Data Corporation, September 1997.

Organizations consider outsourcing a business process when it has the following characteristics.

- The end product of the process is not highly valued by the organization's customers.

- Management would like to spend less time on a process to focus their abilities on improving core activities.
- Management believes that the risk of improving and operating the process can be better managed by an external service provider.
- Quick cost reduction is required.
- Significant capital investment is required and there are competing demands for capital to fund core activities.
- The process can be readily separated from other processes that must remain in-house.

Business processes that require investment, but do not directly relate to the organization's core business, are candidates for alternative delivery methods. By outsourcing these functions, organizations hope to receive from service providers best-in-class processes and systems that they could not afford by keeping the functions in-house. BPO tries to create not only cost efficiency, but enhanced service levels, such as faster monthly reporting, fewer errors, and better tools to help the organization analyze and interpret management information.

## 2.2  What Lies Ahead

By the millennium, Faulkner expects outsourcing to make significant advances within several industries including aerospace, airlines, government, health care, insurance, and banking. Many trends are affecting how organizations look at outsourcing. According to recent research studies:

- Nearly 50 percent of all companies IT budgets in excess of $5 million are either currently outsourcing or are actively considering it.[2]
- 85 percent of banking and finance companies with IT budgets in excess of $5 million are either currently outsourcing or are actively considering it.[3]

- Voice and data network outsourcing is a $2.5 billion market today and will grow by 22 percent per year through 1999.[4]
- 77 percent of Fortune 500 companies currently have efforts underway to outsource some aspect of their business support services.

According to IT outsourcing and BPO growth projections, organizations will increasingly outsource to concentrate on core competencies and to receive superior service levels from their remaining business activities.

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[1] Olson, Lawrence E. (1996). "Outsourcing Market Trends", Faulkner Database, p. 4.

[2] Olson, Lawrence E. (1996). "Outsourcing Market Trends", Faulkner Database, p. 3.

[3] Olson, Lawrence E. (1996). "Outsourcing Market Trends", Faulkner Database, p. 4.

[4] Olson, Lawrence E. (1996). "Outsourcing Market Trends", Faulkner Database, p. 4.

## 3.  KEY FINDINGS

This Section presents the key findings of the *Project EASI/ED Best Practices Study on Outsourcing*.  The Section comprises five subsections, each of which covers a stage in the outsourcing process.  Each subsection discusses one or more outsourcing topics, or subject areas.  Each subject area is explained and illustrated with an example.  Success factors and pitfalls are highlighted for consideration and closing remarks explain the implications of the subject area for ED.

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

Key findings in each of the following subject areas support the stages of the outsourcing relationship.

| 3.1.1 Motivations and Compromises Associated with Outsourcing | 3.2.1 Factors for Selecting a Service Provider | 3.3.1 Preparing for the Outsourcing Relationship | 3.4.1 Organizational Impacts of Outsourcing | 3.5.1 Managing an Outsourcing Relationship |
|---|---|---|---|---|
| 3.1.2 Process for Selecting Functions to be Outsourced | | 3.3.2 Negotiating an Effective Contract | | |

### 3.1  Key Findings – Evaluate Present and Define Goals

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

The following subject areas support the *Evaluate Present and Define Goals* stage.

3.1.1    Motivations and Compromises Associated with Outsourcing
3.1.2    Process for Selecting Functions to Outsource

The purpose of Stage 1 is to assess the current environment and to determine whether outsourcing would be beneficial.  Once the organization determines that outsourcing is appropriate, the organization needs to determine what functions to outsource.  Stage 1 answers the basic outsourcing questions, i.e., "why" and "what."

This subsection discusses the most common drivers for why organizations outsource, along with the risks inherent in outsourcing.  It also describes how organizations decide what functions to outsource based upon internal factors, external factors, and desired outcomes.

### 3.1.1 Motivations and Compromises Associated with Outsourcing

**Description**

The first step in the outsourcing process is to decide whether or not to outsource. Organizations should weigh the benefits and risks associated with outsourcing carefully before making a decision.

**Example**

A $3 billion foreign bank with US headquarters in New York City, decided to outsource its IT operations for the following reasons.

1. *Inability to recruit and retain IT staff.* As a bank, it was difficult to recruit and retain IT staff when competing against IT companies. The outsourcing provider could attract and maintain a much more skilled IT staff. This was the primary driving force to outsource.
2. *Saddled with aging legacy systems.* Rather than invest in upgrades or replacements for old legacy systems, the bank performed patchwork maintenance as needed. Over time, the systems became more and more difficult to maintain because many of the original programmers left the bank without leaving sufficient documentation on the applications or on the maintenance they applied to those applications. With Year 2000 approaching, the bank wanted to shift the burden of solving the problem to an outsourcer.
3. *Long product development cycle.* Competitors were able to introduce new products faster than the bank. By outsourcing project management, the bank felt they could achieve results more quickly.
4. *Best practices.* Many of the people on staff were performing their jobs as they had been for the past 20 years.

The bank wanted to gain access to improved processes by outsourcing.

5. *Desire to reduce staff count.* The bank wanted to let some current staff go and, by outsourcing, the bank was able to have the service provider shoulder the blame.
6. *Inability to staff projects efficiently.* The bank often had multiple concurrent projects that were insufficiently staffed. Outsourcing provides more staffing flexibility by offering a larger pool of resources upon which to draw when needed and the ability to ramp down when needed, as well.
7. *Lack of project management skills.* The bank's 4 to 5 project managers in IT and operations were not delivering on time or providing effective internal communication. The bank felt that outsourcing would provide access to greater skills in project management.

**Success factors**

Organizations that follow best practices use outsourcing to focus on their customers and to increase shareholder value by shifting internal resources away from non-core processes. They use outsourcing as a means to focus internal management on the aspects of their business that distinguish them from the competition. These organizations outsource to obtain the following.

1. *Performance improvement and stabilization.* Many organizations are struggling to stabilize their staff numbers and to perform tasks dependably day-to-day. Outsourcing is a means for organizations to get out of the human resources business for specialized skills.
2. *Continuous improvement.* This motivation is the longer term goal of staying abreast of developments in all areas of business. The classic motivation for outsourcing is from Michael Corbett, co-founder of The Outsourcing Institute,

"Few organizations have the ability to create and maintain world class capabilities in every aspect of their business, yet none can afford to be less than world class in any."

3. *Cost management (not cost reduction).*  Companies would like greater control over their costs, not necessarily to reduce them.  Outsourcing is a means of shifting fixed costs to variable costs by purchasing a service, as needed, from an outsourcing provider.

## Pitfalls

Organizations should outsource for sound business reasons and after careful consideration of the risks involved.  These risks include the following.

1. *Loss of internal knowledge and resources*. Most employees in the affected areas are transferred to the service provider's organization and their obligations shift to that organization.  In addition, employees may leave an organization once an outsourcing initiative is announced.
2. *Loss of control over the function*.  Once a function has been outsourced, the primary means for influencing its performance is through the contract.  If the contract is not written well, the organization may lose control even without a change in business conditions.
3. *Change in business conditions*.  Changes may occur that were not anticipated at the time the contract was signed.  The organization could find itself in a contractual relationship that no longer serves its business needs.  The probability of this risk is increased if an organization does not have a stable service to outsource, e.g., if it outsources a service during or immediately after a reorganization.
4. *One-way trip*.  It may be extremely challenging for an organization to bring a function back in-house if they do not maintain a sufficient level of competence internally.

## Relevance to ED

ED should consider the following key motivations and risks associated with outsourcing.

1. *How to outsource.*  ED already outsources almost all of its IT development and maintenance functions and many other operational functions as well.  The question for ED is less whether to outsource, but rather how much to outsource and how to do it effectively.
2. *Human resources.*  If ED considers outsourcing functions currently performed internally, then it must weigh the human resources impact.  A formal reduction in force may be necessary if ED asks staff to transfer to the service provider and they choose not to do so.
3. *Customer service.*  Improved customer service is potentially the main benefit that government agencies may gain through outsourcing.  Customer service is one of the most visible ways an agency interacts with the public and is emphasized by the Clinton administration through the National Partnership for Reinventing Government (NPR).

### 3.1.2  Process for Selecting Functions to Outsource

**Description**

An organization must know the desired outcomes of outsourcing for it to succeed.  This is particularly important if the organization is using outsourcing to perform a new service.  By envisioning the target environment, the process of deciding what to outsource will become easier and it will lead to a greater return on investment for the organization.

An organization must examine and measure candidate outsourcing functions in detail before approaching a service provider.  This analysis establishes service provider performance expectations and may identify areas of improvement.  This research will also help the organization determine where a service provider can provide the greatest value.

**Example**

In the high interest rate environment of 1988, a foreign government wanted to start an initiative to provide loans for citizens in the lower to middle socio-economic class.  The government wanted to keep the financial aspects of the operation separate from its budget while using the interest rate benefit of a government guaranty.

The government had a solid understanding of what they wanted to accomplish, but not how.  To determine how, the government solicited the private sector for innovative ways to finance housing loans for low-income individuals.  It settled on a hybrid of the suggestions that included outsourcing.

The government then approached a service provider to create a separate legal entity.  The service provider managed back office functions of the separate lending entity while five retailers managed the front office functions including loan origination and customer service.

The boundary separating functions between the government and lending entity is distinct.  The outsourced functions are nearly independent of the organization.  The government provides policy and oversight input to the outsourcing providers and implied financial backing.  That is all.

**Success factors**

The determination of which services to outsource is influenced by the motivations and risks that lie behind the decision to outsource at all.  The following guidelines should be considered.

1. *Determine if the process or activity is of strategic value.*  Processes that hold strategic value, i.e., those that differentiate the organization from the market, should not be outsourced.  Processes that are operational, however, are good candidates for outsourcing.  For example, while Nike outsources almost all manufacturing, its distinguishing characteristics are its product development cycle and brand image.  Nike does not outsource either.
2. *Identify organizational weak links.*  The organization should determine: a) if there are internal staff knowledgeable enough to perform certain tasks, b) whether or not the staff do them well, and c) whether or not the staff will be able to move forward and improve at the necessary pace.  If not, then these tasks are candidates for outsourcing.
3. *Determine if there is an established marketplace for the process.*  If so, the function can probably be outsourced effectively.
4. *Group logical process bundles.*  Combine similar activities that can be outsourced to a single service provider, e.g.,

loan maintenance activities, lockbox and loan collection activities.

## Pitfalls

Common pitfalls when determining the functions to outsource include the following.

1. *Defining the outsourced function too narrowly.* Narrowly defining the outsourced function limits the value a service provider can bring to a solution in two ways. First, it may limit the flexibility needed for innovation. Second, it reduces the likelihood that the service provider can apply previous investments to the problem and achieve economies of scale across multiple clients.
2. *Focusing on inputs or process instead of on outputs.* If an organization focuses on how a function performs instead of what a function delivers, that stifles the innovation that a service provider can bring to bear on the problem.
3. *Outsourcing governmental functions.* Government agencies should ensure they are not outsourcing functions with a political dimension. Agencies should restrict outsourcing to operational functions that only require application of administrative policy.

## Relevance to ED

In determining what functions to outsource, ED should consider the factors listed below.

1. *Separate policy from operations.* Is the function operational? Is the work administrative or does it require day-to-day policy interpretation? Within SFA delivery, separating policy from operations is not always straightforward.

2. *Determine core functions.* Even if the function is purely administrative, is it appropriate that the function be carried out by non-government employees? Is it a 'core' governmental function?
3. *Target specific areas.* What are ED's strengths and weaknesses? In what areas can outside specialists provide the most benefit?
4. *Examine the market.* How generalized is the function being outsourced? Are there service providers with the appropriate skills and experience?
5. *Scope outsourcing candidates properly.* How broadly can ED define the functions that it is outsourcing? Not only does defining functions too narrowly limit the flexibility of the service provider, it also places a larger burden on ED to manage the interaction between multiple outsourced functions.

**3.2 Key Findings – Assess Proposals and Select Provider**

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

The following subject area supports the *Assess Proposals and Select Provider* stage.

3.2.1   Factors for Selecting a Service Provider

The goal of this stage is to select a service provider that can meet or exceed expected service levels at the best cost.

This subsection describes the factors to consider when selecting a service provider and how the outsourcing organization's motivations influence those factors.

### 3.2.1  Factors for Selecting a Service Provider

**Description**

The results from the previous stage, i.e., "why is the organization outsourcing" and "what is the organization outsourcing" strongly influence the selection of a service provider.

"Why" will help determine the necessary characteristics of the service provider.  For example, if the organization is looking for stability, a proven track record could prove the most valuable criterion.

"What" will have an even larger impact on the selection process.  If the outsourcing candidate is a commodity service, such as facilities management and much of IT, availability of personnel could be the most significant factor in selecting a service provider.  If the outsourcing candidate is more complex, the business relationship between the organization and the service provider takes on a more important role.

**Example**

A foreign bank with assets in excess of $100 billion approached the challenge of selecting a service provider in a creative way. It knew, based upon its existing relationships and the research of a consultant, that there were very few providers in the document and print management market who could meet their needs.

The bank first created a 3 to 4 page Letter of Invitation with a list of about 10 desired outcomes in the area of document and print management.  The bank sent the letters to the small group of service providers and asked them to respond with two presentations.  The first presentation focused on the service provider and its qualifications.  The second presentation concentrated on the value the service provider would add to the bank.

After the two 3-hour presentations to key stakeholders, the bank selected a provider based upon their vision and their likelihood of success.  No pricing was considered at this point. In essence, the bank conducted a $1 billion transaction based upon a 3 page letter with no written responses.

**Success factors**

The factors for selecting a service provider generally fall into the "what" and "why" categories.  It is important for the outsourcing organization to have clear reasons for both.

1. *Objective criteria and concrete measures for commodity services.*  Objective, quantitative criteria are most useful when selecting a provider for a service that is a commodity, i.e., widely available from multiple providers.  Specific services and service levels are more universally defined for commodity services.  This increases the usefulness of quantitative comparisons of service providers and the ability to select an appropriate match.

   The maturity of the IT outsourcing market has led many IT services to become commodity services.  The top three evaluative criteria surveyed by Forrester for selecting IT service providers are listed below.  (See also Figure 3.1 at the end of the subject area.)

   a) Available personnel – ability to provide skilled personnel on short notice and in sufficient number.
   b) Service level agreements – levels of service guaranteed by the service provider.
   c) Support offerings – breadth of services provided by the service provider.

2. *Importance of relationship for complex or unique services.* The business relationship becomes more important when selecting a provider for a service that is difficult to quantify. A service can be difficult to quantify if it is complex or new. In both cases, there may be unforeseen problems in performing the service that the organization will need to resolve with the service provider. The organization can achieve resolution most effectively if it has a positive business relationship with the service provider.

Since the BPO market is relatively new compared to IT outsourcing, many of its outsourced services are unique and the criteria for choosing a provider are often different. The top three evaluative criteria surveyed by Dataquest for selecting BPO service providers are listed below. (See also Figure 3.2 at the end of subject area.)

a) Proven track record – demonstrated ability to perform the specific service at the required levels over a period of time.
b) Vendor flexibility – willingness to adjust to the business needs of their clients.
c) Understood my business – unique understanding of the client's business needs.

3. *Know the reason why you are outsourcing.* Regardless of whether the selection process is quantitative or qualitative, there are other selection factors to consider. If the reason the company is outsourcing is performance improvement and stability, then the provider should have a long track record for that service. If the goal is to access new technology, then new service providers may have made the most recent technology investments and could have an advantage. The driver for outsourcing will help an organization select a particular provider based upon its competitive edge.

## Pitfalls

Pitfalls that could lead to an unsatisfying outsourcing relationship when selecting a service provider are listed below.

1. *Wrong reason for outsourcing.* Cost management is frequently a contributing factor in the decision to outsource. If cost reduction is the primary driver for outsourcing, the company and provider will not be in alignment, and no provider will prove to be an ultimately good choice.
2. *Sales representative compensation.* Sales commissions can present a conflict of interest for a service provider's sales representative. To generate a sale, a representative could present a misleading picture of the service capabilities of the provider. Make certain that the interests of the representative are in line with the provider and that the provider can fulfill the representative guarantees.

## Relevance to ED

ED should consider the key factors listed below when selecting a service provider.

1. *Know thyself.* Know why you are outsourcing. Is it for improved quality, cost management, access to specialized skills, or a combination of several reasons?
2. *Determine track record.* How experienced is the service provider at performing the function being outsourced?
3. *Examine the key individuals.* How experienced are the key individuals that will be managing the outsourced function? Are they committed to the contract if it is awarded to that service provider?

4. *Decide if there is a good match.* How well does the service provider understand ED's business?

5. *Check for contract limitations.* What contract vehicle will be used to outsource the function? If an existing contract vehicle (such as the General Services Administration [GSA] Virtual Data Center contract) is to be used, the choice of service provider may already be limited.

To determine the service provider characteristics that organizations value, Forrester Research and Dataquest surveyed organizations that had outsourced IT functions and business processes, respectively. The organizations ranked specific evaluative criteria for selecting a service provider according to their importance on a scale of 1 to 5 with 1 representing 'not important' and 5 representing 'very important'. The scores in Figures 3-1 and 3-2 represent an average ranking of the criterion's importance.
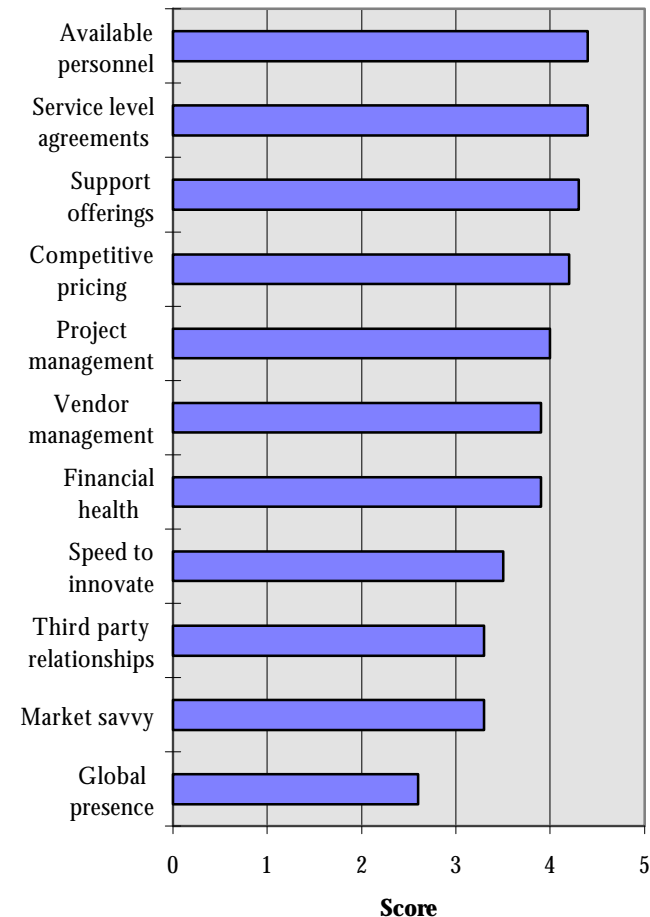


**Figure 3-1 Evaluation Criteria for Selecting IT Service Providers**

Source: Forrester Research, Inc.
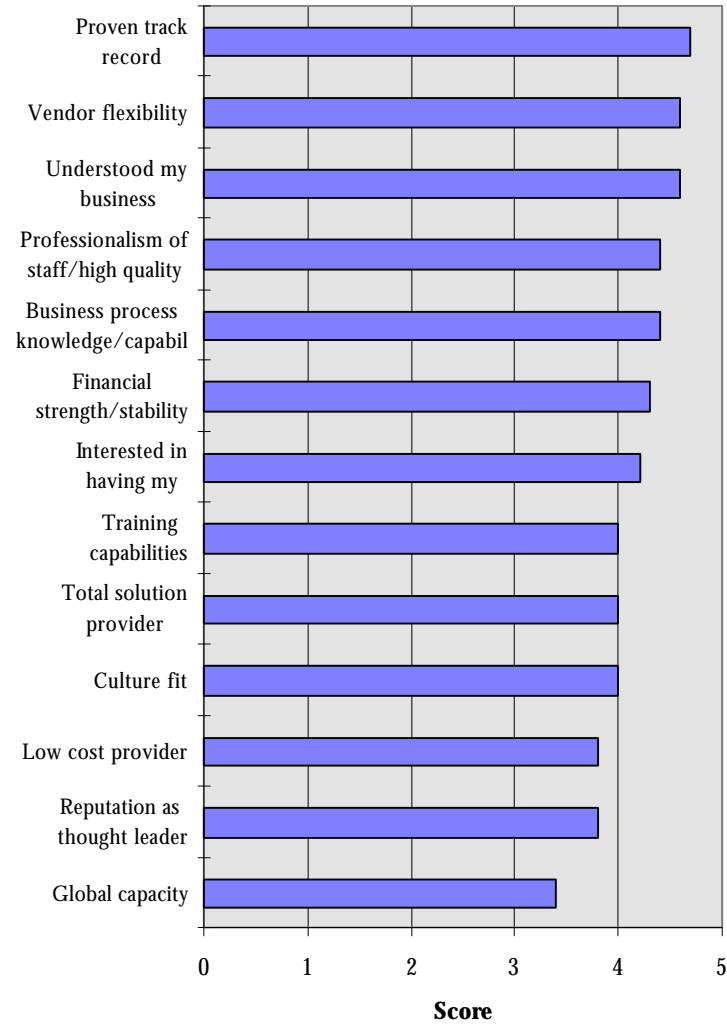
**Figure 3-2 Evaluation Criteria for Selecting BPO Service Providers**

Source: Dataquest.

## 3.3  Key Findings – Prepare and Negotiate Contract

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

The following subject areas support the *Prepare and Negotiate Contract* stage.

3.3.1    Preparing for the Outsourcing Relationship

3.3.2    Negotiating an Effective Contract

The goal of this stage is to prepare for the outsourcing relationship and to establish an agreement with the service provider that provides benefits for both the outsourcing organization and the provider.

This subsection describes the preparation that should take place before entering into an outsourcing contract.  It also specifies items to include in the contract, and factors that may increase a contract's effectiveness.

### 3.3.1  Preparing for the Outsourcing Relationship

**Description**

To increase the chances for a successful outsourcing relationship, the organization must prepare before negotiating the contract.  The organization can prepare before selecting a service provider, or in conjunction with the provider during a due diligence period.  The organization should establish clear performance measures and accountability by mapping the steps and reporting lines of the functions to be outsourced.  Hand-offs between the organization and the provider are ideal points for performance measures.  Both parties use performance measures to define service expectations and to compare actual service levels with those expectations.  Thus, the organization will use performance measures to manage an outsourcing relationship and evaluate its success.

The organization can set minimum desired service levels through external benchmarking if the organization does not perform the outsourced service in-house, or does so poorly.  External benchmarking is the measurement and comparison of operational metrics across organizations and/or industries.

**Example**

A large financial services company with $9 billion in assets and a service provider worked together to determine service levels and accountability.  They both began with a general idea of the scope of the services to outsource.  They worked together to identify the activities associated with the outsourced functions and to define who would be responsible for performing those activities: the company, the provider, or both.  They mapped out processes at an appropriate level of detail.  The guiding principle was that the company would be responsible for policy and the provider would be responsible for process.  Activities that resulted in hand-offs were identified for potential service

level measurements that could apply to the company, the provider, or third-parties.

**Success factors**

The following guidelines should be considered when establishing, monitoring, or updating performance measures for the service provider.

1. *Focus on outputs, not on inputs.*  Organizations hire service providers to deliver a service.  Performance measures should focus on the provider's ability to deliver outputs, not on its internal processing.
2. *Handful of metrics.*  Use only a handful of activities or measurements that truly reflect the success of the outsourcing relationship (up to 6.)
3. *Monthly metrics.*  Obtain management metrics every month.  While metrics are not hard indicators, they help both the provider and the customer to understand current activities and they help with trend analysis.
4. *Benchmarking.*  Hire independent, third-party experts to perform periodic industry benchmarking.  The organization should hire the experts to avoid potential conflicts of interest with the service provider.  In addition, the organization should mandate benchmarking and its frequency in the contract to ensure the organization conducts the studies.

**Pitfalls**

Pitfalls to avoid when employing performance measures are listed below.

1. *Focusing solely on costs.*  Costs are one measure and do not reflect the benefits of the outsourcing relationship.
2. *Establishing too many service levels.*  There is a temptation to measure a great number of items, but that leads to the

expenditure of energy by the service provider and the organization on measuring performance, not providing service.

3. *Setting service levels too low based upon in-house performance.*  If an organization is operating extremely inefficiently and they establish service levels based upon internal measures, they may create a profit windfall for the service provider.  The organization should improve in-house operations or base measures upon external benchmarks.

4. *Not raising service levels over time.*  If a service provider consistently achieves levels of performance meriting incentives, the organization should adjust the levels upwards so the provider achieves them infrequently.

5. *Establishing the baseline too late.*  If the organization establishes a performance baseline after an outsourcing relationship begins, it may be difficult to create meaningful measures.  Companies must understand their own processes from both a cost and a performance perspective before they can look outside and make meaningful comparisons with other organizations.[5]

### Relevance to ED

ED should take the steps listed below as it prepares to enter an outsourcing relationship.

1. *Focus on outputs.*  Define the outputs of the outsourced function, not the steps to perform the function.

2. *Select a few metrics.*  Agree upon a few critical metrics to measure the quality of service provided.

3. *Measure current performance.*  Understand and measure internal processes before the function is outsourced.  This preparation allows a meaningful comparison between the service provider's performance and ED's current capabilities.

4. *Hire independent help.*  Have independent experts perform periodic industry benchmarking.

5. *Update contract.*  Adjust the service levels periodically based upon the service provider's performance and upon comparable industry benchmarks.

### 3.3.2  Negotiating an Effective Contract

**Description**

A major tool in establishing a successful outsourcing relationship is a well-written contract.  A well-written contract helps the outsourcing organization meet its requirements, while allowing the service provider to make a fair profit.  Though the contract will not be able to predict or solve all potential problems, a properly constructed agreement certainly helps. (See Appendix D for a sample contract outline.)

**Example**

A financial services company with approximately $2 billion in annual revenue employed BPO and IT outsourcing extensively. Because of its experience with outsourcing, it possessed the internal knowledge needed to negotiate a partnership with the service provider.  The company and the provider signed a 10-year contract with exit provisions for both organizations. Exhibits in the contract included the following items.

1. Definition of service levels
2. Definition of how to measure the levels
3. Definition of the roles and responsibilities of those involved in providing the service
4. Guaranteed levels of service with penalties for under-performance

The baseline service levels were established by measuring activities at the company during transition.

The company and the provider spent 30 days developing a set of business principles that covered the value proposition. They also drafted a change management plan that outlined the transfer of services and the incorporation of company employees into the provider organization.

**Success factors**

General success factors for establishing an effective contract are listed below.

1. *Obtain qualified legal advice.*  Organizations outsourcing for the first time may want to employ the services of a lawyer to help them through the legalities of setting up an effective outsourcing deal.  Service providers often have these resources on hand, whereas very few organizations do.
2. *Service Level Agreements.*  Outsourcing contracts frequently include Service Level Agreements (SLAs) as exhibits.  They detail specific operating and support requirements for each service at agreed upon levels of performance.  Organizations track service levels using previously defined performance measures.  There are entire best practice studies devoted to SLAs.  For more information, see Hawkins, S.  "Service Level Agreements For Outsourcing."  Gartner Group, May 1997.
3. *Evergreen mechanisms.*  Evergreen mechanisms are tools used to periodically update the contract.  The most common evergreen mechanism is a benchmarking agreement. Benchmarking agreements provide a means of comparing how an organization is performing relative to those considered "best-in-class."  Independent third parties funded by the organization should conduct the benchmarking studies.  Organizations should write benchmarking studies into the contract on an annual or biannual basis to ensure they are performed.

Because of the scope of this subject area, the reader is advised to review additional sources on the topic for more information, particularly Terdiman, R., L. Cohen, T. Berg, "Negotiating Outsourcing Contracts," Gartner Group, September 1997, and

Hawkins, S. "Performance Target Guidelines For Outsourced Services," Gartner Group, April 1998.

## Pitfalls

Common pitfalls in establishing a successful outsourcing contract include the items below.

1. *Vagueness.*  Detail is the hallmark of a successful contract. Despite service provider assurances that both parties can work out the details later, the organization should work them out to the extent possible before signing the contract. This is particularly true when setting service levels.
2. *Unrealistic service levels.*  While the possibility of setting service levels too low was addressed in the previous subject area, there is also the chance of setting them too high during contract negotiations.   This may occur due to overzealousness of the service provider or unrealistic expectations by the customer.
3. *Not utilizing evergreen mechanisms.*  There is a temptation not to conduct benchmarking studies when relations between the organization and service provider are going well.   The organization should avoid this temptation in order to assure that they are getting best practice services at a reasonable cost throughout the life of the arrangement.
4. *Lack of escalation procedures.*  Escalation procedures are formal procedures for resolving issues or disagreements not described in the contract.  Contracts should include them because both parties cannot cover or know every issue during negotiations.

## Relevance to ED

ED should take the following steps in negotiating an outsourcing contract.

1. *Legal advice.* Obtain qualified legal assistance if necessary. Service providers have experienced outsourcing contract lawyers on staff who specialize in negotiating that providers' specific services.  ED should be represented by experienced outsourcing contract lawyers who specialize in the same services and who have experience drafting creative service level and fee agreements that reflect the latest trends in the industry.
2. *Service levels and reporting lines.*  Agree to service levels and draw specific lines of accountability in the contract, not at a later time.
3. *Benchmarking.*   Include benchmarking agreements in the contract.  These agreements should state that ED will pay for an independent, third-party study to update the service levels on an annual or bi-annual basis.
4. *Escalation procedures.*  Document explicit procedures for escalating and resolving issues not covered in the contract.

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[5] Bendor-Samual, Peter.  (1997).  "Make sure your outsourcer delivers on promises", Business Communications Review, volume 27, issue 8, p. 35.

**3.4  Key Findings – Begin Transition Process**

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

The following subject area supports the *Begin Transition Process* stage.

3.4.1    Organizational Impacts of Outsourcing

The goal of this stage is to navigate successfully the organizational transition.

This subsection discusses organizational impacts to consider when outsourcing.

### 3.4.1  Organizational Impacts of Outsourcing

**Description**

Organizations must manage significant organizational impacts carefully for outsourcing to succeed.  If not, the outsourcing initiative could fail early on or simply fail to reach its full potential.

There are two main groups impacted by outsourcing: those who transfer to the service provider and those who remain.  For those who transfer, the fundamental issues will surround job function, job location, salary, benefits and career path.  Those who remain will need to adapt to change too, most often by developing new job skills.

**Example**

In January 1996, a $3 billion foreign bank with operations in New York, decided to outsource its IT-related back office functions.  Prior to the transition, a service provider worked with the bank's human resources (HR) department to obtain employment information such as compensation, benefits, etc..  Using that information, they built a one-page sheet with three columns listing:

| 1. Category/benefit | 2. Current value | 3. To-be value |
|---|---|---|

With this sheet, workers could easily equate any differences from their current pay and benefits with the bank to their future pay and benefits with the service provider.  For example, if a worker currently had 3 weeks vacation and the service provider was offering 2 weeks, the provider adjusted their salary to compensate for the lost week.

Once these sheets were ready, the bank executives held meetings with department managers prior to the outsourcing announcement.  The bank used the outsourcing announcement as an opportunity to let some people go.  Those people attended a different meeting where bank executives explained that due to outsourcing, some services were moving to different locations and that their positions had been cut.

The bank sent all of the others to a different meeting where they announced the outsourcing decision.  The service provider was at this meeting and introduced itself to the employees.  This group of employees then went over the comparison sheets with corporate HR, one-on-one, to discuss the differences.  As a result, people knew where they stood organizationally and personally.

**Success factors**

People are frequently the most challenging dimension to manage during the transfer of operations from in-house to the service provider.  An organization should consider a number of activities to facilitate the process.  They are listed below.

1. *Communicate regularly and appropriately.*  To lessen the impact of outsourcing, an organization needs to inform employees clearly and often with appropriate detail of the organization's plans and how the employees fit in to those plans.  The organization will need different messages for those who transfer to the service provider and those who remain within the organization.
2. *Plan for staff transfer.*  For staff moving to the service provider, both parties must address numerous issues, such as skill sets, job functions, benefits, compensation, and physical facilities.
3. *Guarantee positions for transferring staff.*  Whenever possible, the service provider should guarantee employees positions for a specified period of time.  The time period should be long enough for them to demonstrate their

capabilities but not so long as to place a burden on the service provider. For high-demand sectors, like IT, this should not be difficult.

4. *Plan for a culture shift internally.* There are often numerous issues to address for staff who stay with the customer organization as well. That is because organizations frequently affect culture change within the organization in conjunction with the outsourcing engagement. Organizations need to make employees aware of new expectations and to educate them on how to interact with the outsourced functions.

5. *Phased implementation.* Another way to lesson the human impact is to phase in outsourcing. Organizations can phase in outsourcing by function or region. Phasing in outsourcing allows staff to become accustomed to it and it may allow the service provider to replace in-house positions as they become open due to retirement or other departures. While most outsourcing situations do not have the luxury of phasing in implementation, it may make the transition smoother when it is possible.

## Pitfalls

Often people do not welcome change and would rather leave. There are common pitfalls to avoid to minimize this reaction.

1. *Not including employees in the transition plan development.* This misses out on valuable input and does not give the employees any sense of ownership over the decision.

2. *Not clearly communicating to the employees the outsourcing transition steps.* Confusion spreads fear and people will assume the worst. It is better to communicate clearly and frequently.

3. *Not explaining to the employees how they will be impacted organizationally* and *personally.* While employees will want to hear about what is happening to the organization, they will want to know what that means to them personally.

## Relevance to ED

ED should be aware of the following key organizational impacts when outsourcing.

1. *Manage staff transition.* Since ED already outsources a large number of functions, transferring ED staff to a service provider is unlikely to be an issue. However, in the event that a staff transfer is necessary, it could prove the most difficult aspect of the change to manage.

2. *Examine Service organizations.* ED's current contracts are aligned by Service (e.g., Program Systems Service, Debt Collection Service, etc.). The Band Strategy and EASI/ED could outsource functions that cut across current organizational boundaries. ED may need to reexamine the current Service organizations to manage the contracts effectively.

3. *Maintain qualified staff.* ED's IT contracts are currently organized so that an entire system is managed through a single contract. The Band Strategy (and potentially EASI/ED) would change that. One of the most difficult aspects of managing the future contract architecture would be the coordination of multiple service providers to provide continuous, high quality service. While ED can seek outside assistance to help in the coordination effort, it is vital that ED retain a staff of highly knowledgeable individuals who can provide long term continuity in both technical and program knowledge.

**3.5  Key Findings – Manage Contract**

| Stage I | Stage II | Stage III | Stage IV | Stage V |
|---------|----------|-----------|----------|---------|
| Evaluate Present and Define Goals | Assess Proposals & Select Provider | Prepare and Negotiate Contract | Begin Transition Process | Manage Contract |

The following subject area supports the *Manage Contract* stage.

3.5.1    Managing the Outsourcing Relationship

The goal of this stage is to manage the outsourcing relationship so that both the outsourcing organization and the service provider are able to perform in their core competencies.

This subsection describes how to manage effectively an outsourcing relationship.

### 3.5.1  Managing the Outsourcing Relationship

**Description**

The success of an outsourcing relationship can often be determined in the first 60 days.  During the first 60 days, both parties set the tone of the relationship by working through some kinks that inevitably arise during the beginning of the relationship.

**Example**

The relationship between a foreign bank with assets in excess of $100 billion and its document and print management service provider was a strategic partnership.  The service provider effectively stepped into the bank's shoes and was seen as the "Document and Print Management Department" by employees in the bank.

The bank managed the relationship, not the work.  The boundary between the service provider and the bank was clear.  All of the bank's current positions that related to providing document or print management services became the service provider's.  The same points of interface that existed before outsourcing remained after outsourcing, including all management functions.  The bank was responsible for anything that included the use of forms or images only.

**Success factors**

A number of factors influence the success of an outsourcing relationship.

1. *Selection of a contract manager.*  The ability of the organization to manage an outsourcing relationship is critical and contributes to the value that both parties derive from the relationship to a great extent.  This places a great deal of responsibility on the shoulders of the organizational

representative.  The person must be able to balance the need to keep sufficient control of the relationship while not exercising too much control.  The manager must ensure that the organization does not lose leverage by losing knowledge or skills over time while not diluting the efficiencies gained by outsourcing in the first place.

2. *Management support for outsourcing.*  Management should support the relationship by supporting outsourcing as a concept and as a method to fulfill their needs.  Management needs to back up its commitment with a willingness to hold people accountable for implementing that method.

3. *Vision and communication.*  It helps the service provider understand the organization's needs if the organization has a clear vision of what it wants to be 2, 5, or 10 years from now and can communicate that effectively.  If that communication is there, the service provider can more efficiently incorporate the necessary capabilities.

4. *Partnership attitude.*  For BPO in particular, it is important to treat the relationship as a partnership because both parties will learn lessons along the way.

5. *Both parties win.*  The organization should not try to win at the expense of the service provider in the short term.  Both parties must benefit for outsourcing to be effective.  Outsourcing relationships are a lot like marriage, i.e., both parties need to make it work and there is no one winner.

**Pitfalls**

The main pitfalls to establishing a successful outsourcing relationship reflect how it is managed.

1. *Too hands-on.*  Once the outsourcer begins telling the service provider how to perform the outsourced function, it defeats the primary benefit of outsourcing – to bring innovative, world class capabilities to bear on a business

problem. The outsourcer must learn to manage the contract, not the work.

2. *Too hands-off.* If the manager of the contract does not stay actively involved, the manager poses a risk to the organization and the provider. Over time, the organization can lose the skills and knowledge necessary to perform the work effectively in-house, or worse, lose the ability to manage the service provider effectively because it no longer understands the business. From the service provider's perspective, if the organization does not stay actively involved, there is the risk that customer expectations are not being met and that future customer needs are not being considered.

3. *Too adversarial.* It is shortsighted to treat the service provider as an expense to be minimized or an adversary to beat. Both organizations benefit by the success of the other.

4. *Internal effectiveness.* Not only must the contract manager be able to manage the service provider effectively, the manager must be effective within the organization as well. This means that the manager needs to be well-respected and knowledgeable about the function outsourced.

5. *Not planning for worst-case scenarios.* In addition to establishing issue escalation procedures, both parties should plan for worst-case scenarios.

## Relevance to ED

ED should consider the factors listed below when managing the outsourcing relationship.

1. *Build technical manager skills.* ED needs to build a core staff of technically expert employees who can manage and coordinate the activities of multiple service providers. This is particularly important for a scenario such as the Band

Strategy, where several different service providers could be working on the same system over an extended period.

2. *Define Department vision.* ED needs to define a concrete vision for where it wants to be over the next five to ten years. Creating and changing outsourcing contracts is a long and complicated process, and a road map for the future is necessary for ED to plan transitions effectively.

## 4. SUMMARY

This Section summarizes the subject areas for the stages of the outsourcing process and describes their relevance to ED.

### 4.1 Motivations and Compromises Associated with Outsourcing

The first step in the outsourcing process is to decide whether or not to outsource. ED should weigh the benefits and risks associated with outsourcing carefully before making a decision.

ED should consider the following key motivations and risks associated with outsourcing.

1. *How to outsource.* ED already outsources almost all of its IT development and maintenance functions and many other operational functions as well. The question for ED is less whether to outsource, but rather how much to outsource and how to do it effectively.
2. *Human resources.* If ED considers outsourcing functions currently performed internally, then it must weigh the human resources impact. A formal reduction in force may be necessary if ED asks staff to transfer to the service provider and they choose not to do so.
3. *Customer service.* Improved customer service is potentially the main benefit that government agencies may gain through outsourcing. Customer service is one of the most visible ways an agency interacts with the public and is emphasized by the Clinton administration through the National Partnership for Reinventing Government (NPR).

### 4.2 Process for Selecting Functions to Outsource

ED must know the desired outcomes of outsourcing for it to succeed. By envisioning the target environment, the process of deciding what to outsource will become easier and it will lead to a greater return on investment. Also, ED must examine and measure candidate outsourcing functions in detail before approaching a service provider to determine where a service provider can add the greatest value.

In determining what functions to outsource, ED should consider the factors listed below.

1. *Separate policy from operations.* Is the function operational? Is the work administrative or does it require day-to-day policy interpretation? Within SFA delivery, separating policy from operations is not always straightforward.
2. *Determine core functions.* Even if the function is purely administrative, is it appropriate that the function be carried out by non-government employees? Is it a 'core' governmental function?
3. *Target specific areas.* What are ED's strengths and weaknesses? In what areas can outside specialists provide the most benefit?
4. *Examine the market.* How generalized is the function being outsourced? Are there service providers with the appropriate skills and experience?
5. *Scope outsourcing candidates properly.* How broadly can ED define the functions that it is outsourcing? Not only does defining functions too narrowly limit the flexibility of the service provider, it also places a larger burden on ED to manage the interaction between multiple outsourced functions.

## 4.3  Factors for Selecting a Service Provider

The results from the previous stage, i.e., "why" and "what", strongly influence the selection of a service provider.

"Why" will help determine the necessary characteristics of the service provider.  For example, if ED is looking for stability, a proven track record could prove the most valuable criterion.

"What" will have an even larger impact on the selection process.  If the outsourcing candidate is a commodity service, such as facilities management and much of IT, availability of personnel could be the most significant factor in selecting a service provider.  If the outsourcing candidate is more complex, the business relationship between ED and the service provider takes on a more important role.

ED should consider the key factors listed below when selecting a service provider.

1. *Know thyself.*  Know why you are outsourcing.  Is it for improved quality, cost management, access to specialized skills, or a combination of several reasons?
2. *Determine track record.*  How experienced is the service provider at performing the function being outsourced?
3. *Examine the key individuals.*  How experienced are the key individuals that will be managing the outsourced function?  Are they committed to the contract if it is awarded to that service provider?
4. *Decide if there is a good match.*  How well does the service provider understand ED's business?
5. *Check for contract limitations.*  What contract vehicle will be used to outsource the function?  If an existing contract vehicle (such as the GSA Virtual Data Center contract) is to be used, the choice of service provider may already be limited.

## 4.4  Preparing for the Outsourcing Relationship

To increase the chances for a successful outsourcing relationship, ED must prepare before negotiating the contract.  ED should establish clear performance measures and accountability by mapping the steps and reporting lines of the functions to be outsourced.  Hand-offs between ED and the provider are ideal points for performance measures.  Both parties use performance measures to define service expectations and to compare actual service levels with those expectations.

ED can set minimum desired service levels through external benchmarking if it does not perform the outsourced service in-house, or does so poorly.  External benchmarking is the measurement and comparison of operational metrics across organizations and/or industries.

ED should take the steps listed below as it prepares to enter an outsourcing relationship.

1. *Focus on outputs.*  Define the outputs of the outsourced function, not the steps to perform the function.
2. *Select a few metrics.*  Agree upon a few critical metrics to measure the quality of service provided.
3. *Measure current performance.*  Understand and measure internal processes before the function is outsourced.  This preparation allows a meaningful comparison between the service provider's performance and ED's current capabilities.
4. *Hire independent help.*  Have independent experts perform periodic industry benchmarking.
5. *Update contract.*  Adjust the service levels periodically based upon the service provider's performance and upon comparable industry benchmarks.

## 4.5  Negotiating an Effective Contract

A major tool in establishing a successful outsourcing relationship is a well-written contract.  A well-written contract will help ED meet its requirements, while allowing the service provider to make a fair profit.  Though the contract will not be able to predict or solve all potential problems, a properly constructed agreement certainly helps.

ED should take the following steps in negotiating an outsourcing contract.

1. *Legal advice.*  Obtain qualified legal assistance.  Service providers have experienced outsourcing contract lawyers on staff.  Government agencies rarely do.
2. *Service levels and reporting lines.*  Agree to service levels and draw specific lines of accountability in the contract, not at a later time.
3. *Benchmarking.*  Include benchmarking agreements in the contract.  These agreements should state that ED will pay for an independent, third-party study to update the service levels on an annual or bi-annual basis.
4. *Escalation procedures.*  Document explicit procedures for escalating and resolving issues not covered in the contract.

## 4.6  Organizational Impacts of Outsourcing

ED must manage significant organizational impacts carefully for outsourcing to succeed.  If not, the outsourcing initiative could fail early on or simply fail to reach its full potential.

ED should be aware of the following key organizational impacts when outsourcing.

1. *Manage staff transition.*  Since ED already outsources a large number of functions, transferring ED staff to a service provider is unlikely to be an issue.  However, in the event that a staff transfer is necessary, it could prove the most difficult aspect of the change to manage.
2. *Examine Service organizations.*  ED's current contracts are aligned by Service (e.g., Program Systems Service, Debt Collection Service, etc.).  The Band Strategy and EASI/ED could outsource functions that cut across current organizational boundaries.  ED may need to reexamine the current Service organizations to manage the contracts effectively.
3. *Maintain qualified staff.*  ED's IT contracts are currently organized so that an entire system is managed through a single contract.  The Band Strategy (and potentially EASI/ED) would change that.  One of the most difficult aspects of managing the future contract architecture would be the coordination of multiple service providers to provide continuous, high quality service.  While ED can seek outside assistance to help in the coordination effort, it is vital that ED retain a staff of highly knowledgeable individuals who can provide long term continuity in both technical and program knowledge.

## 4.7  Managing the Outsourcing Relationship

The success of an outsourcing relationship can often be determined in the first 60 days.  During the first 60 days, both parties set the tone of the relationship by working through some kinks that inevitably arise during the beginning of the relationship.

ED should consider the factors listed below when managing the outsourcing relationship.

1. *Build technical manager skills.*  ED needs to build a core staff of technically expert employees who can manage and coordinate the activities of multiple service providers.  This is particularly important for a scenario such as the Band Strategy, where several different service providers could be working on the same system over an extended period.
2. *Define Department vision.*  ED needs to define a concrete vision for where it wants to be over the next five to ten years.  Creating and changing outsourcing contracts is a long and complicated process, and a road map for the future is necessary for ED to plan transitions effectively.

## APPENDIX A – ACRONYMS

The acronyms used in this document and their definitions are listed below.

| | |
|---|---|
| BPO | Business Process Outsourcing |
| DBA | Database Administrator |
| EASI | Easy Access for Students and Institutions |
| ED | United States Department of Education |
| FACCTS | Faulkner's Advisory on Computer and Communications Technologies Database |
| FTE | Full-Time Equivalent |
| GAO | General Accounting Office |
| GSA | General Services Administration |
| GPRA | Government Performance and Results Act |
| HR | Human Resources |
| IS | Information Systems |
| IT | Information Technology |
| LAN | Local Area Network |
| LTD | Limited |
| MIS | Management Information Systems |
| NPR | National Partnership for Reinventing Government |
| OMB | Office of Management and Budget |
| OPE | Office of Postsecondary Education |
| PW | Price Waterhouse LLP |
| PWFS | Price Waterhouse Financial Solutions |

| | |
|---|---|
| RFP | Request For Proposal |
| SFAP | Student Financial Assistance Programs |
| SLA | Service Level Agreement |
| SR | State Route |
| UK | United Kingdom |
| US | United States of America |
| US$M | US currency, $1 Million |

## APPENDIX B – INTERVIEW SCRIPTS

The following generalized interview scripts were used to conduct the best practice interviews:

1. *General.* The goal was to learn about outsourcing best practices in general.
2. *Government-specific.* The goal was to uncover and learn about issues pertinent to the government.

Items in brackets, e.g., [Why. Original motivation for outsourcing], detail how the answer to the question was intended to be used.

## General

*1. What is outsourcing?*

[What. How is the relationship defined.]

*2. Why do organizations outsource?*

[Why. Original motivation for outsourcing]

[Why. Continuing motivation for outsourcing.]

*3. What are some guidelines to determine the functions that can be outsourced most effectively?*

[How. Guidelines that determine the functions that can be outsourced most effectively.]

*4. What are the organizational impacts to consider when outsourcing?*

[How. What are the organizational impacts to consider when outsourcing.]

*5. What are the factors to consider when selecting a vendor?*

[How. What are the factors to consider when selecting a vendor.]

[How. Implication -- What is the process for selecting a vendor.]

*6. What makes for an effective contract/SLA?*

[How. What makes for an effective contract/SLA.]

[What. What are the pieces that define an outsourcing relationship.]

[How. Implication -- What is the process for defining the outsourcing relationship.]

*7. How can the success of an outsourcing relationship be determined?*

[How. How can the success of an outsourcing relationship be determined.]

*8. What are the factors that determine the success or failure of an outsourcing relationship?*

[How. How can the success of an outsourcing relationship be determined.]

*9. What advice do you have for other organizations considering outsourcing?*

[General. Key findings.]

**Government-focused**

*1. What are the main benefits to outsourcing for a government agency?*

[Why. Original motivation for outsourcing]

[Why. Continuing motivation for outsourcing.]

*2. What are the main risks that a government agency should consider before outsourcing?*

[Why. Original motivation for outsourcing]

[Why. Continuing motivation for outsourcing.]

*3. How do government agencies approach outsourcing as a relationship?*

[What. How is the relationship defined.]

*4. How does the current legal and regulatory environment affect the government's ability to outsource?*

[What. What are the pieces that define an outsourcing relationship.]

[How. Implication -- What is the process for defining the outsourcing relationship.]

*5. What are some guidelines that determine government functions that can be outsourced most effectively?*

[How. Guidelines that determine the functions that can be outsourced most effectively.]

*6. What are the organizational impacts to consider when outsourcing?*

[How. What are the organizational impacts to consider when outsourcing.]

*7. What considerations must be taken into account when selecting a vendor?*

[How. What are the factors to consider when selecting a vendor.]

[How. Implication -- What is the process for selecting a vendor.]

*8. Are there additional provisions that should be included in the contract or SLA for a government outsourcing relationship?*

[How. What makes for an effective contract/SLA.]

[What. What are the pieces that define an outsourcing relationship.]

[How. Implication -- What is the process for defining the outsourcing relationship.]

*9. What should a government agency use to determine the success of the outsourcing relationship?*

[How. How can the success of an outsourcing relationship be determined.]

*10. What advice would you give to a government agency that is going to outsource? i.e. what are the things to do, what are the things to avoid?*

[General. Key findings.]

## APPENDIX D – SAMPLE CONTRACT OUTLINE

**I.      Term of Agreement**

A.      5 - 10 years
1.      Option of client renewals
2.      Beyond 10 years at mutual agreement between parties

**II.     Definitions (examples of terms to be defined)**

A.      Critical Function
B.      Continuing Services
C.      Service Levels
D.      Account Executive
E.      Pool of Resources
F.      Transferred Assets
G.      Transition Services

**III.    General Scope of Work**

A.      General Operations
1.      Specify sites and nature of processing - type, frequency, location
2.      Resources to be assumed by location - people, property, leases, and any maintenance responsibilities
B.      Operations Recovery - including disaster, back-up and retrieval process, off-site storage
C.      Operations - Processing and Systems Documentation
D.      Levels, Type of Training for Client Users
E.      Forms, Supplies, Postage, etc.
F.      Cooperation/support of Third Party Vendors
1.      At client's discretion
2.      Constraints of environment

**IV.     Real Property Hardware/Software Licenses**

A.      Lease Assumptions
B.      Asset Disposal/Responsibility, Expected Return, Timeframe/FMV
C.      Ownership of Furnishings, Obligations to Provide
D.      Assumption of Third Party Leases and Client Exposure
E.      Applications
1.      Specify all applications
2.      Replacement of applications with "similar or better" products
3.      Applications to be excluded including office automation or other departmental computing
4.      Level of resources to support applications for modifications, development or enhancements
F.      Client Software Licensing
1.      Outsourcer only has right to process for client
2.      Client owns all enhancements/modifications whether paid of not
3.      Outsourcer may only market with client approval; client has right to royalty beyond contract term

**V.      Pricing of Services**

A.      Baseline
1.      Structure
2.      Methods of adjustment
3.      Services included
B.      Other Pricing for Services
1.      Incremental (growth)

2.     Basis for charging
3.     Breakdown of pricing by type
C.   Other Charges
1.     Out-of-pocket - nature/type
2.     Sales/excise taxes
3.     Inflation adjusters
a)     Frequency
b)     Categories of costs applied to
c)     Limitations on application
D.   Method for Invoicing
1.     Contents of invoice
2.     Timing
3.     Notification of disputed amounts; timeframe for resolution; deduction of amount in dispute
E.   Most Favored Nation Clause
F.   Telecommunication Charges
1.     Pass-thru or in base
2.     No administration fee

## VI.    Performance/Service Levels

A.   Business Processes
1.     Current volumes
2.     Key process benchmarks and performance levels
3.     Bandwidth parameters
B.   Systems/Telecommunications
1.     Reference to existing measure/ experience
2.     Limit to critical applications, processes, reports
C.   Performance Adjustments
1.     How measured
2.     Timing for applying

3.     Timeframe for correction

## VII.    Software Development and Support

A.   Level of Support/Man Hours/FTEs/Skill Type
B.   Key Personnel
C.   Third Parties - Use of and Obligation to Support
D.   Differentiation Between Maintenance and Development

## VIII.    Other Issues

A.   Transition Period and Related Issues
1.     Key Employees
2.     Benefit Programs
3.     Transition Plan
4.     Disruption of Service
5.     Timeframe/Expenses
B.   Audit Rights
1.     Use of Third Party
2.     Access to "Confidential" Data
3.     Frequency/Notice
C.   Cost Savings Projects
1.     Sharing of Savings
2.     Approval Prior to Changes
D.   Liability
1.     Limitations
2.     Consequential
3.     Actual
4.     How Measured/When Applied
5.     Method of Reimbursement (Escrow)
6.     Arbitration/Continuing Performance
E.   Governing Law (state where client is located)
F.   Indemnification/Force Majeure
G.   Termination/Post Termination Assistance
1.     Early Termination, Breach, Cause, Insolvency, Non-Payment

          2.       End of Contract
          3.       Nature of Support and Cap of Expenses
          4.       Exposure of Payment for Remaining Contract Years

H.     Procurement of Hardware
          1.       At Cost
          2.       Above/Below Cost

I.      Transferability of Contract

J.      Marketing Rights

## APPENDIX E – BIBLIOGRAPHY

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